

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Legend

Trust

State 1
State 2
Bank
Date 1
Date 2
Date 3
Grantor
Child 1
Child 2
Child 3
State Court

State Statute 1
State Statute 2

a
b
c

Dear :

This letter responds to your February 25, 2010 letter and other correspondence requesting a generation-skipping transfer (GST) tax ruling concerning the proposed modifications of Trust.

The facts submitted are as follows:

On Date 1, Grantor established Trust, an irrevocable trust, for the benefit of his descendants. Trust was initially funded with assets contributed by Grantor. Grantor timely filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for the transfer to Trust and allocated \$a of his GST exemption to Trust. As a result of the allocation, Trust has an inclusion ratio of zero. No further contributions have been made to Trust since the initial transfer. The current trustee is Bank.

Article 2-1.1(a) of Trust provides, in relevant part, that the trustee is to hold, manage, invest and reinvest the property comprising the trust, collect the income, and distribute all, none, or such part of the net income among the members living from time to time of a class of beneficiaries composed of Grantor's descendants in such amounts, shares and interests as the trustee in trustee's absolute discretion may from time to time determine.

Article 2-1.1(b) provides, in relevant part, that the trustee may distribute from time to time, to any then living member of the class of beneficiaries composed of Grantor's descendants, such amounts of principal as the trustee in trustee's absolute discretion determines to be necessary or desirable for any such beneficiary's health, education, maintenance, and support.

Article 2-1.3 provides that Trust is to terminate upon the first to occur of the death of the last survivor of Grantor's descendants or the expiration of the rule against perpetuities of State 1. Upon termination, all property then comprising the trust is to be distributed to Grantor's then living descendants.

On Date 2, pursuant to Article 4-2.2(x), the trustee changed the situs of Trust from State 1 to State 2. Since Date 2, the trust is governed by the laws of State 2, except that the applicable rule against perpetuities is still subject to the laws of State 1.

The beneficiaries of Trust petitioned State Court to reform Trust. The beneficiaries include Child 1, Child 2, and Child 3, and, through court appointed representation, Grantor's living grandchildren and all other minor, incapacitated, unborn or unknown individuals who are now or in the future will become descendants of Grantor. Pursuant to the reformation, Trust is to be split into four separate subtrusts. Three of the subtrusts will be unitrusts, one for each branch of Grantor's family: a unitrust for the family of Child 1, a unitrust for the family of Child 2, and a unitrust for the family of Child 3. Each of the unitrusts will be funded with b percent of the overall cash and cash equivalents of Trust or \$c, whichever is greater. The balance of Trust, consisting of the remaining cash and cash equivalents and all other assets of Trust, is to be held in the fourth subtrust, known as the Family Trust, which will continue to be administered under the terms of Trust as it existed prior to the reformation.

The Trust provisions governing the unitrusts are as follows: Article 3-1 of the reformed Trust provides, in relevant part, that the primary beneficiary of each unitrust

shall be the Grantor's child. The descendants of Grantor's child shall also be additional beneficiaries of such unitrust. However, the trustee should primarily look to the Family Trust as a source for making distributions to the descendants of the Grantor's child so long as that child is living. In each full taxable year, the trustee is to pay to the primary beneficiary of the unitrust an amount equal to 5 percent of the net fair market value of the unitrust assets valued as of the last business day of the prior taxable year. In addition to the unitrust amount, the trustee may pay as much of the principal of the unitrust to the primary beneficiary as the trustee feels is desirable for the health, education, maintenance, and support of the primary beneficiary.

Article 3-1(g) of the reformed Trust provides, in relevant part, that upon the death of a primary beneficiary, his or her interest in the unitrust is to be administered for the benefit of the primary beneficiary's children, by representation. Until each of the primary beneficiary's children has attained age 25, the trustee is to pay the unitrust amount to the primary beneficiary's children and the descendants of any deceased child of the primary beneficiary, as the trustee, upon consultation with the trust advisors, considers to be in their best interests. Any of the unitrust amount that is not distributed is to be accumulated and added to the principal of the unitrust. After all of the deceased primary beneficiary's children have attained age 25, the trustee is to distribute all of the unitrust amount to the deceased primary beneficiary's children, by representation. If there are descendants of a deceased child of the deceased primary beneficiary who have not attained age 25, then the trustee is to pay only as much of their respective share of the unitrust amount as the trust advisors deem appropriate and the balance of their respective share is to be accumulated and added to their share of the principal of the unitrust. If the deceased primary beneficiary has no surviving descendants then the deceased primary beneficiary's unitrust amount is to be allocated to the Grantor's children and their descendants, by representation, by adding to and augmenting the other unitrusts which are being held for Grantor's children and their descendants.

State Statute 1 provides that the percentage to be used in determining the unitrust amount shall be a reasonable current return from the trust, in any event not less than 3 percent nor more than 5 percent taking into account the intentions of the settlor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust.

State Statute 2 provides, in relevant part, that following the conversion of an income trust to a total return unitrust or upon creation of a total return unitrust by a settlor, the trustee shall treat the unitrust amount as if it were net income of the trust for purposes of determining the amount available, from time to time, for distribution from the trust.

On Date 3, State Court entered Order reforming Trust, subject to the trustee's receipt of a private letter ruling from the Internal Revenue Service regarding the proposed modifications to Trust.

You have requested the following ruling:

The proposed modifications of Trust will not alter the inclusion ratio of Trust for GST purposes so that, after the modifications are effected, Trust, which includes the four subtrusts, will maintain an inclusion ratio of zero.

LAW AND ANALYSIS

Section 2601 of the Internal Revenue Code imposes a tax on every GST which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the GST tax shall not apply to any GST under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer was not made out of corpus added to the trust after September 25, 1985, (or out of income attributable to corpus so added).

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax (because the trust was irrevocable on September 25, 1985) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Unless specifically noted, the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the

modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or person who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 7, illustrates a modification that does not shift an interest to a lower generation. In the example, Grantor established an irrevocable trust in 1980 for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, per stirpes. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, per stirpes, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, per stirpes. In 2002, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation beneficiary because the modification does not increase the amount of a GST transfer under the original trust or create the possibility that new GST transfers not contemplated in the original trust may be made. In this case, the modification will increase the amount payable to A, who is a member of the same generation as B and C. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust as modified will not be subject to the provisions of chapter 13.

Section 26.2601-1(b)(4)(i)(E), Example 11, considers a situation where a trust that is otherwise exempt from the GST tax because it was irrevocable prior to September 25, 1985, provides that trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. State X, the situs of the trust, then amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. The example concludes that the administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount will not be considered to shift a beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, under the facts of the example, no trust beneficiary will be treated as having made a gift

for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes.

No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust.

In this case, the proposed modifications will not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed modifications will not extend the time for vesting of any beneficial interest in the subtrusts beyond the period provided for in Trust. Therefore, provided the proposed modifications meet the requirements of State 2 law, we conclude that the proposed modifications of Trust, which includes the four subtrusts, will not alter the inclusion ratio of Trust for GST purposes so that, after the modifications are effected, Trust will maintain an inclusion ratio of zero.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

The rulings in this letter pertaining to the federal estate and/or generation-skipping transfer tax apply only to the extent that the relevant sections of the Internal Revenue Code are in effect during the period at issue.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures

Copy for § 6110 purposes

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